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SUBJECT: UKRAINE: BOIKO DISCUSSES YANUKOVYCH'S ENERGY
PRIORITIES

Classified By: Ambassador John F. Tefft for Reasons 1.4 (b) and (d).

¶1. (C) Summary. In an introductory call with the Ambassador on February 23, Yuriy Boiko, a leading energy player in the Party of Regions, said that Yanukovych would be focused on reducing Ukrainian dependence on Russian gas imports, securing a better gas contract with Gazprom, and establishing a gas transit consortium with Russian and European partners. Boiko also addressed, limitedly, the need for domestic energy price reform and underlined that Ukraine must improve its investment climate to develop its oil and gas fields. Boiko, formerly Minister of Fuel and Energy, Chairman of Naftohaz, and one of the founders of RosUkrEnergo, will likely play a key role in energy policy under a new government. His, and Regions' generally, commitment to transparency and reform in the energy sector remains to be seen. End summary.

Reduce Dependence on Russian Gas Imports

¶2. (C) Yuriy Boiko, former Minister of Fuel and Energy, chairman of Naftohaz and one of the founders of shady gas intermediary RosUkrEnergo (RUE), told the Ambassador in a February 23 meeting that newly elected President Yanukovych would work to strengthen Ukraine's energy independence. Boiko said that in the past two years Ukraine has become more sensitive to energy disruptions because of its growing dependence on Russian energy sources. As President, Yanukovych would work to increase Ukraine's coal mining output and develop its own natural gas fields to reduce dependence on Russian gas imports. Boiko noted that Yanukovych had begun a program to develop Black Sea oil and gas deposits during his time as Prime Minister.

¶3. (C) Boiko said that Ukraine should develop a climate that would attract international investment in its oil and gas deposits, especially in the Black Sea. Boiko stressed that Ukraine needs political stability and better legislation to attract much needed investment in the sector and suggested that Azerbaijan's legislation could serve as a model for Ukraine. Boiko also suggested that Ukraine should consider developing LNG capacity, with a regasification terminal in Odesa with a capacity of 4.5 billion cubic meters per year. Boiko noted that Ukraine has developed good contacts with Libya and Egypt, which could serve as potential suppliers of LNG. In addition to developing LNG capacity, Boiko said that Ukraine should restart its cooperation with Turkmenistan. He noted that prior to the January 2009 gas contracts with Russia, Ukraine had imported a large share of its gas from Turkmenistan and argued that it had, therefore, not been as

dependent on Russian gas.

Renegotiate Gas Contracts with Russia

¶4. (C) Yanukovych's second priority, according to Boiko, would be to renegotiate the January 19, 2009 gas supply and transit contracts with Russia. The contracts are the most damaging to Ukraine since its independence, Boiko contended. Boiko claimed that Ukraine is paying 40% more for gas imports than Italy and 20% more than Germany. Ukraine also is being underpaid for transit, Boiko said, alleging that transit rates in Slovakia and Hungary are two times what Ukraine is paid. While not only crippling the state-owned gas company Naftohaz, the gas contracts have severely harmed Ukrainian industry, especially the chemical sector, Boiko stated. Boiko said that Ukraine must find a model under which it pays Russia less for the gas it imports.

¶5. (C) Boiko did not elaborate on how Yanukovych would secure agreement for a lower gas price from Russia but suggested that the Russians could agree to lower prices in exchange for participation in a gas transit consortium. Boiko also said that Ukraine would raise with Gazprom that other countries pay less for Russian gas than Ukraine does. He concluded that Ukraine does not need a low price for Russian gas but rather "transparent, understandable prices."

Establish a Gas Transit Consortium

¶6. (C) Establishing a transit consortium would be the third main priority for Yanukovych, Boiko said. Boiko noted that Russia's plans to build North and South Stream undermine the competitiveness of the Ukrainian gas transit system (GTS). Boiko said that South Stream especially was a real danger for Ukraine and that a top priority of a new government would be to stop plans for South Stream. Ukraine must attract international partners to its GTS in order to remain competitive, Boiko argued. While Boiko first stated that Ukraine must work with all of its partners, including Turkmenistan, Kazakhstan, and Uzbekistan but not listing Europe, Boiko later underlined that the key to establishing a gas transit consortium would be to secure European agreement.

¶7. (C) Boiko said that Yanukovych would raise the transit consortium idea with the European Union during his first trip to Brussels on March 1. Boiko noted, though, that when Ukraine first proposed the idea of a transit consortium in 2002, lack of interest from European companies halted its development. Boiko suggested that Ukraine study the Caspian oil consortium as a possible model for a gas transit consortium. In a separate conversation on February 26, Iryna Akimova, Deputy in Yanukovych's newly-formed Presidential Administration told Acting Economic Counselor that some German firms had expressed initial interest in participating in a consortium and that the EBRD may be willing to provide financing. However, she said that it would take time to determine whether there was serious interest from EU firms.

Preventing Corruption

¶8. (C) Asked by the Ambassador how corruption could be prevented in the gas trade, Boiko again stressed the importance of international partners. Boiko argued that corruption could be minimized by having international actors, who would demand international standards for audits. Boiko acknowledged that a consortium would be very controversial in Ukraine and that it must be done in an "almost" transparent and legal manner. (Comment: Boiko believes he speaks better English than what he does. One would hope that his statement was a language mistake and not a harbinger of what is to come. End comment.)

¶9. (C) Boiko also said that under Yanukovych, the March 23

Brussels declaration between the EU and Ukraine would be strengthened and implemented. Naftohaz would be "unbundled" with separate entities handling production, transit, and retail operations. Ukrtransgaz, he said, would be the transit operator, while Naftohaz would become a trading company.

Need to Raise Domestic Gas Prices

¶10. (C) Boiko admitted, after being asked by the Ambassador, that Ukraine would have to raise household and heating company gas prices. Boiko said that the new government would also develop a targeted subsidy system to assist those unable to pay higher prices. Boiko estimated that if Ukraine raised gas prices to 20% more than what Russians pay for gas, Naftohaz would earn an extra \$3 billion per year. (Note: Russian gas prices averaged \$85 per thousand cubic meters (tcm) in 2009 and are expected to be \$96/tcm in 2010. Households in Ukraine are charged, on average, around \$60/tcm, and heating companies pay \$88/tcm. End note.) Boiko said \$1 billion of the extra revenues raised from higher gas prices would be used to fund the targeted subsidy program. Boiko also noted that raising gas prices would create a more favorable investment climate for development of Ukraine's gas deposits.

Open to American Investment in Nuclear Sector

¶11. (C) On nuclear issues, Boiko noted that he was the first in Ukraine to negotiate with Westinghouse and said that Yanukovych's team was "ready" to cooperate with Westinghouse again. He argued that Westinghouse's previous proposals failed in Ukraine because the company did not offer as attractive conditions as its Russian competitors did. Boiko said Ukraine would consider building American nuclear reactors.

¶12. (C) Comment. Boiko's focus on renegotiating the gas contracts and establishing a gas transit consortium, over needed domestic energy reforms, echoes what other top Regions' officials have told us. However, securing lower gas prices from Russia alone will not save the financially crippled Naftohaz. Nor will the company secure needed support from international financial institutions, without energy reforms. Establishing a gas transit consortium is clearly a key priority for Yanukovych. Whether a share in the Ukrainian GTS is enough to convince Russia to renegotiate the January 2009 gas contracts remains a question. Boiko also did not address how European energy companies' need for transparency and international accounting standards would be matched with Gazprom's likely desire for less openness in the gas trade. Boiko's suggestion that Ukraine again turn to Turkmenistan for gas supplies fails to take into consideration that those supplies would still need to transit through Russia. Boiko was coy about what role he might have in a new government, but many here expect him to play a key role in energy policy, perhaps again being named Minister of Fuel and Energy. Unfortunately, his past role in RUE raises concerns about Party of Regions' true commitment to transparency and rule of law in the energy sector. End comment.
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